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SUBJECT: TURKEY'S ECONOMY: GROWING CONCERNS OVER AK ECONOMIC POLICIES

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¶1. (SBU) Summary: The AK Government's indecisiveness on economic reforms is continuing to damage market confidence. The latest evidence was weak demand in T-bill auctions January 7. The key issue for restoring market confidence lies in fiscal policy, where the GOT needs to announce and implement spending cuts. These cuts will pay for already announced new spending measures (civil servant salary and pension increases), and will help make the 6.5 percent primary surplus target, which is needed to pay debt service this year, more credible. The cuts are also needed to meet a key condition under the pending IMF program. The budget shortfalls have already created a short-term cash flow problem, per Turkish Treasury debt experts, since the GOT needs to pay debt service of about $2.6 billion on January 8 and meet a GOT payroll of over $1 billion on January 15. Meanwhile, the AK leadership is talking publicly about potential USG compensation to Turkey because of Iraq, adding to the potential moral hazard. End Summary.

The Good News To Date - Inflation and Monetary Policy

¶2. (U) 2002 was a good year for Turkey's macro-economic fundamentals, as the year-end inflation data demonstrate. Annual growth, though not known precisely for several more months, is also estimated to be between 6.5 to 7 percent. Annual inflation targets were met on both CPI (29.7 percent versus target of 35 percent) and WPI (30.8 percent versus 31 percent target). This was Turkey's lowest inflation since 1983, better even than under the 2000 crawling peg regime (which resulted in 32 percent CPI). Furthermore, the Central Bank appears to be firmly in control of monetary policy. As the year ended, Central Bank Governor issued a statement about Iraq scenarios, stating that the 2003 growth and inflation targets could be achieved, despite any external shocks, if the GOT implemented the reform program.

¶3. (SBU) Looking forward into 2003, the challenge of continuing the disinflationary trend will be difficult. Monthly CPI inflation appears stuck at about 2 percent in seasonally adjusted terms. Achieving the 2003 year-end target of 20 percent CPI will require another break in inflationary expectations.

¶4. (SBU) The GOT's recently announced fiscal stimulus measures - civil servant wage and pension increases - will have the opposite effect, and make the disinflation targets even more difficult. Hurriyet columnist Erdal Saglam phrased it this way in his January 6 column: "As for this government, we haven't seen any commitment to disinflation until now, other than empty rhetoric. On the contrary, the latest pension fund increases - amounting to at least TL 3 quadrillion in new spending - will serve to stimulate pricing behavior. With this kind of decision, inflation will not decline but rather will veer upward."

The Bad News - Fiscal Shortfall

¶5. (SBU) The economic policy focus of the markets remains on the GOT's preparations for the 2003 budget, and on conditions. On the budget, the initial indications are not

good.

-- The GOT fell short of meeting the 6.5 percent of GNP primary surplus in 2002 by about two percent of GNP (over $3 billion). The current government blames this shortfall, rightly, on pre-election spending by the prior GOT.

-- However, the first quarter 2003 budget submitted by the new GOT is also short of meeting the primary surplus target by at least $1 billion, in the first quarter alone.

-- Furthermore, the GOT has announced new spending initiatives in 2003: a civil servant wage increase estimated by the GOT to cost TL 3.5 quadrillion in 2003 (but may cost more); and a pension benefit increase estimated by the GOT to cost TL 3 quadrillion, but estimated by the World Bank to cost TL 4.5 quadrillion.

-- The GOT has not announced any expenditure cuts to pay for this new spending.

¶6. (SBU) Ministry of Finance officials have given us some indications of measures they are planning to take to cut spending. They are confident that, if the GOT takes all these proposed spending cut measures, then the 6.5 percent GNP target is achievable for 2003. (Comment: One credible market commentator, Bender Securities of Istanbul, believes that meeting the 6.5 percent primary surplus in 2003 is now virtually impossible, given the already large 2002 shortfall. End Comment.)

-- First, Finance Ministry U/S Arioglu told us January 6 that the "tax peace" law just submitted to parliament will result in about TL 2 quadrillion in tax revenue. (The law restructures long-standing tax arrears, eliminates some penalties and, in theory, leads to more tax payments).

-- Second, Finance Ministry budget expert Kesik told us recently of other measures discussed with the IMF and agreed to in the Ministry, including: controlling pharmaceutical costs (by enforcing existing co-payment conditions by beneficiaries; this condition is usually overlooked); expanding coverage of social security premium payments (by making more of the beneficiaries' salaries subject to the premium payments); cutting unproductive public investments (e.g., in new hospitals and other buildings in the social security institutions); stopping the agricultural price subsidies (and relying only on direct income support payments to the farmers); and reducing losses in the state economic enterprises.

¶7. (SBU) Comment: We agree with Kesik that quickly adopting and publicizing these measures is the best way to assure markets of the GOT's solvency in 2003. But the spending cuts will be difficult politically, and thus the GOT is hesitating to announce and implement them. The pharmaceutical co-payment measure was leaked to the press on January 6.

Fiscal Shortfall Translates into Immediate Cash-Flow Problem

¶8. (SBU) The first quarter primary surplus shortfall is forcing the government to turn more to its domestic debt market to raise funds for immediate needs. This market is already facing large debt roll-over demands, and Treasury's debt expert Volkan Taskin says Treasury's goal is to roll-over 95 percent of its debt owed to the market this month. In January, the Treasury domestic debt redemption schedule focuses on two large payment dates:

Date	Payment to Market	Total Payment
Jan. 8	$2.0 billion	$2.6 billion
Jan. 22	$3.3 billion	$3.4 billion

Total domestic debt redemption in January: $7.5 billion (at exchange rate of TL 1,650,000 to the dollar).

¶9. (SBU) Treasury's current cash balance is about TL 2.5 quadrillion, per Taskin, and some of this cash can be used to pay the January 8 redemption, since the January 7 auctions (see below) did not find enough demand. The Treasury may have a cash flow problem next week, January 13-15, when it pays

a GOT salary payroll of about TL 1.8 - 2 quadrillion. (The GOT pays salaries twice monthly, on the 15th and end of month, but it begins transferring funds to banks to make the payroll one to two days in advance.) Taskin says Treasury may schedule a dollar-linked bill auction for later in the week because, "there is liquidity in the market."

¶10. (SBU) Results of January 7 T-bill auctions were not positive.
Yields were slightly higher than market expectations, at 57.1 percent on the five-month bill and 59.6 percent on the nine-month bill. The Treasury raised only TL 1.5 quadrillion from the market in the two auctions.

Structural Reforms - No Progress

¶11. (SBU) World Bank lead economist in Turkey Jim Parks told us January 7 that he saw "no progress" on the structural reform agenda. Furthermore, discussion of the World Bank's main loan to Turkey, the Programmatic Public and Financial Sector Adjustment Loan, has been delayed to end March to give the GOT time to draft a new letter of intent.

-- On privatization, Deputy PM Sener (in charge of privatization) has not approved the Privatization Administration's 2003 plan, nor has he authorized the PA to announce the winning bids on about $200 million in assets that were auctioned in October. The PA is keeping the auction bids sealed until it receives instructions. Sener did task the PA with a list of board members of the state enterprises (257 positions which the new GOT could fill with their own people).

-- On the Public Procurement Law, the GOT came under pressure from the IMF, World Bank and EU when it announced plans to delay the scheduled January 1 implementation date. Instead, the GOT allowed the law to come into force, but then proposed to parliament a series of amendments to limit the scope of the law (e.g., excluding procurement by municipalities and state economic enterprises). These amendments also proved controversial, and they remain in parliamentary committee. The British Embassy told us that the EU member countries are organizing a joint demarche to the GOT against the proposed amendments, which would be contrary to EU codes.

-- On banking sector reform, resolution of Pamukbank and the ownership of Yapi Kredi bank remains a critical condition for completing the Fourth Review, per IMF resrep. Talks between owner Cukurova Holding and the Banking Board (BRSA) are "deadlocked," per BRSA Vice Chairman Pazarbasioglu. BRSA has agreed to a restructuring of Cukurova's $2 billion in loans from Yapi Kredi, and this news cheered the markets and lead to a 18 percent rise in Yapi's stock. But this restructuring is conditioned on an overall agreement with Cukurova on ownership issues by January 31. In the meantime, the mainstream Turkish press (owned by Cukurova Holding rival Dogan Holding) has been accusing the GOT and BRSA of bailing out Cukurova owner Karamehmet with public money.

Comment on Market Reaction

¶12. (SBU) The local financial markets have continued to weaken since their December 3 height: T-bills rates are up 9 percentage points; the Istanbul Stock Exchange index has lost about one third; the lira has depreciated about 10 percent. Market sources are citing worries about the fiscal shortfalls as a major factor in today's weak demand in the T-bill auctions. Behind the fiscal problem lies a political concern heard in the markets that the AK government is disunited and unable to reach agreement on key economic policies.

¶13. (SBU) The GOT leadership is attempting to counter these concerns by hinting to its public that budget shortfalls will be covered by the USG through the Iraq scenario - see for example PM Gul's December 30 briefing to the press (ref b). This GOT spinning of recent discussions with the U.S. is helping inculcate a moral hazard in the markets. IF this calculation is part of the GOT's thinking as well, it will be increasingly hard to sell it on the reforms still needed. But any possible future assistance can only serve to delay the GOT's market reckoning, if it doesn't adopt appropriate economic reform policies.
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